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SUBJECT: VENEZUELA'S BANKING SECTOR: ARE THE GOOD TIMES OVER?

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Classified By: Acting Economic Counselor Shawn E. Flatt for reasons 1.4 (b) and (d).

¶1. (SBU) Summary: Over the last four years, Venezuela's banking sector has registered rapid growth and record profits. The good times may be ending, however. The economy is slowing down; the BRV has tightened monetary policy to counter inflation; and banks are subject to increasing government regulation (though few anticipate nationalization). Many local financial analysts believe that several small or medium-sized private banks will fail as the larger macroeconomic boom peters out, but few predict contagion or the sort of systemic breakdown that occurred in the 1994 banking crisis. End summary.

Venezuela's Banks: Largely Private But Heavily Regulated

¶2. (SBU) According to Superintendency of Banks (SUDEBAN) statistics, 60 banks were operating in Venezuela at the opening of 2008. 39 of these banks are classified as universal or commercial banks and are authorized to perform classic retail bank functions; the others are more specialized. The number of banks, which is large relative to the size of Venezuela's economy, masks the sector's heavy concentration. Five private banks - Banesco, Banco Mercantil, Banco de Venezuela (owned by Grupo Santander), Banco Provincial (owned by BBVA), and Banco Occidental de Descuento - control 50 percent of the sector's assets (including cash, loans, and investment in securities - principally BRV debt), while the smallest 24 banks control only 3 percent. Ten of the 60 banks are state-owned. Seven of the ten are specialized and three are universal banks, including the Banco del Tesoro, which was created in 2005 partly to manage the government's treasury functions. The public banks' share of overall assets is 10 percent, indicating that the BRV has not yet made a major foray into the sector, at least by BRV standards. Several public banks regularly lose money and require capital injections to stay afloat.

¶3. (SBU) With one or two exceptions, our contacts do not expect the BRV to nationalize the banking sector because it knows it would be incapable of managing effectively the critical services the sector provides. Instead, the BRV has chosen to assert control over the sector through increasingly onerous regulations. The Central Bank (BCV) sets minimum interest rates for deposits, maximum interest rates for loans (sometimes on a sector-specific basis), and, recently, maximum fees for a wide variety of services. Banks must direct up to 47 percent of their loan portfolios to housing, tourism, small businesses, agriculture, and, most recently, manufacturing. (Note: The effective percentage is lower given calculation methodologies. End note.) A recent statement by Minister of Planning and Development Haiman El Troudi to the effect that banks had "pocketed a good part" of the gains of recent economic growth and that "the hour has arrived to tell them that they will profit less" suggests that further regulation is on the way, perhaps in the form of the long-anticipated banking law.

2004-2007: Lots of Money with Nowhere to Go

¶4. (SBU) Two factors explain banks' performance from 2004 into 2007: strict exchange controls, which were implemented in 2003, and massive government spending, which increased over 140 percent in nominal terms from 2004 through 2007. These factors led to trapped and rising liquidity combined with strong economic growth - in other words, more money circulating through a growing economy for banks to profit from. Banks' assets grew over 400 percent in nominal terms from January 2004 through December 2007 (from 38 to 205

billion bolivars (Bs), with one USD equivalent to 2.15 Bs at the current official exchange rate), and annual pre-tax profit grew 90 percent from 2004 to 2007 (from Bs 2.8 to 5.3 billion). While impressive, these figures are not as stunning as they appear at first blush. They must be interpreted in light of the 2002-2003 recession (which led to a low starting point in 2004) and high inflation rates (accumulated inflation of 55 percent from mid-2004 to mid-2007).

¶5. (SBU) It would be a mistake to interpret banks' recent growth as a sign that the sector is making a healthy contribution to a healthy economy. Real interest rates on deposits are sharply negative, and as a result people deposit money in banks to finance transactions but not to save. Although real interest rates on many loans are slightly negative (though higher enough than deposit rates that banks still make money on the spread), private investment is minimal given the uncertain economic climate (ref C). Many loans simply finance consumption. Indeed, credit card and auto loans grew 93 percent during 2007 (24 percentage points faster than overall loans), and the total amount of these loans is currently three times the amount loaned to the manufacturing sector. The BRV itself is both an important source of deposits and recipient of banking sector assets. The public sector accounts for roughly 18 percent of all bank deposits, and about 14 percent of banks' assets are in BRV debt. Given the spreads, recycling BRV money is a profit center for many banks and, of course, a source of losses for the BRV (ref A). The fact that BRV debt is tax free and does not count toward assets in calculating banks' capital to assets ratio provides additional incentives for banks to hold BRV debt. (Note: SUDEBAN has established a minimum capital to assets ratio of 8 percent and aminimum capital to risk-weighted assets ratio of 12 percent, minimums which by international standards are relatively high. Banks that hold BRV debt and whose capital adequacy ratios are at these minimums are therefore not necessarily undercapitalized. End note.)

¶6. (SBU) At year-end 2007, banks' assets, which amounted to Bs 205 billion (USD 95 billion at the official rate), were divided as follows: cash and reserves, 24 percent; investments in securities, 22 percent; loan portfolio, 48

percent; and other assets, 6 percent. Of the loan portfolio, banks directed 52 percent to commercial enterprises (including 7 percent to manufacturers), 22 percent to credit cards and auto loans; 11 percent to the agricultural sector; 9 percent to mortgages; and 5 percent to tourism and small businesses. Banks' liabilities totaled Bs 187 billion (USD 87 billion), of which deposits represented 86 percent. Of the deposits, 52 percent were in checking accounts, 22 percent in savings accounts, 11 percent in time deposits, and the rest in other deposit types.

2008: Less Growth and Less Money with Nowhere to Go

¶7. (SBU) There are indications that 2008 will not be as good to banks as the previous four years. On the macroeconomic level, economists' predictions of lower growth and higher inflation appear accurate. Concerned about inflation, the BCV is implementing a tighter monetary policy that began in 2007 with raising the reserve requirement from 15 percent to what is now approximately 23 percent and has continued in 2008 with increases to the minimum interest rate for deposits and the maximum rate for credit card loans, as well as more aggressive open market operations. The BRV has contributed to tighter liquidity conditions for private banks by moving some of its deposits to public banks and by sales of structured notes (ref B).

¶8. (SBU) Although opinions differ as to the relative importance of these various BCV and BRV actions, they have clearly had a collective impact. M2 - a measure of liquidity that includes currency, checking and savings deposits, and certain time deposits and money market funds - has dropped 2.6 percent since the beginning of the year; the average lending rate at the six major banks has risen from 16.8

percent (2007 average) to 23.2 percent (mid-April, 2008); credit expansion has been much lower (1 percent in the first quarter of 2008, compared to 11 percent in the same period in 2007); and the interbank overnight rate has both risen on average and become more volatile. Bad loans, while still low overall, have crept up from 1.2 percent (year end 2007) to 1.6 percent (March 31, 2008). Even if liquidity growth picks up in the second half of 2008 as the BRV spends in advance of regional elections, it appears that banks' easy days are winding down. Interestingly, despite the more challenging environment banks' pre-tax profit continued to show healthy growth in the first quarter of 2007 (profit was 19 percent higher per month on average than during the last six months of 2007). At least some of this growth is attributable to structured note sales (ref B). These sales are essentially gifts from the BRV to selected banks, one of several ways in which BRV policy directly contradicts the sentiments expressed by El Troudi about bank profits.

How Vulnerable Is the Financial Sector?

¶9. (C) While there is no doubt that banks will suffer as Venezuela's macroeconomic boom ends, a key question is whether vulnerabilities in the financial sector could either spark or accelerate an economic crisis. This question has particular relevance given Venezuelans' strong memories of the 1994 banking crisis, where widespread structural problems in the banking sector led to the failure of banks representing more than one third of market share. Econoffs have raised this question with senior bank executives and leading economists, financial analysts, and businesspeople over the past five months. The vast majority see a real possibility that several small or even medium-sized banks will fail over the coming two years but are not concerned about contagion.

Not a Case of Deja Vu...

¶10. (C) According to most contacts, the principal reason the financial sector is not at risk for a major meltdown is the improvement in banks' management and lending standards. Industry analysts attribute much of this improvement to the presence of foreign banks such as BBVA and Grupo Santander, which were allowed to enter the market beginning in 1994 (and did so in force starting in 1996), rather than BRV oversight. While there is consensus that SUDEBAN, the BRV's primary regulator, is stronger than in the early 1990s in terms of technical staff, most contacts characterize SUDEBAN head Trino Diaz as far more concerned about supporting the BRV's political agenda than regulating banks. Bank executives do not feel that the directed lending requirements are significantly undermining their standards, perhaps partly because SUDEBAN has not imposed fines where banks have not been able to meet the requirements. BanCaribe President Miguel Purroy (strictly protect) noted that the BRV was not forcing banks to lend to specific individuals or projects, a step which, should it occur, would be the "beginning of the end" for banks. Ruth de Krivoy (strictly protect), a leading economic consultant who was president of the BCV during the 1994 crisis, said that she would be concerned primarily if foreign banks began pulling out of Venezuela or if an "upstart bank favored by Chavez" started buying out larger and more established banks.

¶11. (C) A second reason most analysts do not anticipate a major financial meltdown is the presence of foreign exchange controls, which did not exist in 1994. Several contacts have characterized the controls as the banks' "insurance policy": even if Venezuelans began to lose confidence in the sector as a whole, they would be less likely to make a run on their banks because it would be harder to shift their money abroad. Yet even with their improved management, relatively ample provisions for bad loans, and the "insurance policy" of exchange controls, executives at several of Venezuela's most respected banks have acknowledged a certain degree of unease,

with different operational consequences. Banco Mercantil and Citibank executives said they were trying to reduce the maturities of their loans as much as possible, to maintain maximum flexibility. Several executives at other banks said that they would purposefully slow the growth of consumption loans and, more generally, noted the reluctance of many banks to increase their capital.

...But Some Smaller Banks at Risk

¶12. (C) As noted above, most of our contacts believe it is possible or probable that several small or medium-sized banks will fail in the next two years. Vulnerable banks generally fall into one or more of three categories: newer banks, banks with solvency problems, and banks with liquidity problems. Newer banks, established to take advantage of easy overall liquidity conditions, tend to have to pay more to attract private deposits, and, with credit portfolios more vulnerable to rising interest rates, they have a higher proportion of bad loans. Out of 55 banks for which specific information was available at year-end 2007, 12 had capital adequacy ratios below the established minimum and 17 had capital to risk-weighted assets ratios below the established minimum, although SUDEBAN has not forced them to raise more capital. (Note: Although they are out of compliance, not all of these banks would be considered undercapitalized by international standards - see note in paragraph five. End note.) Finally, when the BRV began to move deposits from private banks to the Banco del Tesoro, a number of banks suffered liquidity problems as well and have been forced to go to the interbank overnight market. According to financial consultant Francisco Faraco (strictly protect throughout), the Banco del Tesoro is supplying most of the necessary interbank loans, a situation which highlights these banks' dependency on the BRV.

¶13. (C) Should several smaller banks fail, most analysts discount the possibility of contagion because the vulnerable

banks represent a small proportion of the overall sector and there are not strong linkages between these banks and the stronger, larger private sector institutions. Both Faraco and Carlos Hernandez (strictly protect), a BanCaribe Board Member and former BCV director, noted that the overall interbank market is relatively small, and even smaller between private banks. The Venezuelan Banking Association's chief economist also noted that there are no significant correspondent banking relationships between Venezuelan banks. Indeed, many of our contacts believe that, rather than lead to contagion, the failure of several smaller banks would open the way for a healthy consolidation of the sector and/or for further entry of foreign banks.

Comment

¶14. (C) We share the majority view that the financial sector will not spark or contribute unduly to the acceleration an economic crisis in Venezuela. The deep vulnerabilities of Venezuela's economy (ref C) are not of banks' making, and the larger banks, which control the lion's share of the market, generally appear well managed, well provisioned, and aware of potential vulnerabilities. While banks' loan portfolios, and particularly consumption loans, grew at an unsustainable rate from 2004 to 2007, they have recently slowed significantly. Indeed, credit growth has been sharply negative in real terms during the first quarter of 2008, a sign that banks are turning to a more conservative approach (as well as a reflection of tighter monetary policy). There are two caveats to our view, however. First, we will not know the full truth about the strength of banks' portfolios until the crunch comes. Second, as always, there is the unpredictability of BRV policy. Irrational as it might seem, it is possible that the BRV will change course and seek to nationalize major parts of the financial sector, either to access its resources or as the logical conclusion to a potential campaign of blaming banks for the country's economic woes. Should the BRV take this step, all bets are off.

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